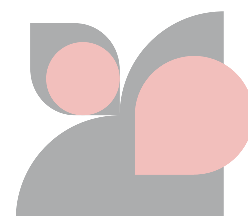

Rathbones Specialist Tax Portfolio Service (STPS)

The Specialist Tax Portfolio Service team

Q4 2022 report

A year of transition

It was a challenging year for smaller company investors, with the FTSE AIM All-Share index ending 2022 down 31%. Yet we see grounds for cautious optimism as we head into the new year. Investor sentiment became markedly more pessimistic in the latter half of the year - arguably, in our view, overshooting. AAII Sentiment Survey data show that the number of 'bearish' investors has fallen from a high of 60.9% in September to 42% of respondents as of 4 January.

We believe we are closer to the end than the beginning of what has been a difficult transition period to a new economic cycle - the AIM market rose by 3.6% in the final quarter of 2022, with our client returns, largely, outperforming this figure.

Investors appear to be reacting to short-term economic data points rather than the exciting long-term growth potential that we see in our stocks. Many of these are currently valued at multi-year lows despite resilient operational performances. We believe the catalyst for rerating 'growth' stocks (i.e. an increase in their price-earnings (PE) multiples) will come progressively as investors are weaned from 'following the Fed' and recognise longer-term challenges addressed by dynamic smaller companies.

Some of the key issues facing companies in 2022, such as supply chain constraints, staff recruitment and retention, elevated wage pressures, and the now-abandoned Chinese 'zero COVID' policy, should start to ease in 2023. Inflation and interest rates will continue to drive sentiment and valuation in the short term. Central banks say bringing down inflation is their priority, and the pace of interest rate increases gives some weight to the hope that inflation might start to fall in the coming year.

There are, of course, a wide range of variables and potential near-term outcomes. We place our confidence in robust company fundamentals over macro forecasts and are focused on investing in small companies with strong management, superior growth prospects, durable profit margins and conservative levels of debt. Sustainable, growing earnings, backed by strong cash generation, should ultimately determine share prices, and we believe our companies will be rewarded in the long run.

An encouraging Santa rally

We have seen encouraging rallies over the past quarter in some stalwart holdings whose share prices were unfairly marked down in the wider sell off. Those that have kept up with trading updates from the likes of RWS and Renew will not be surprised.

Renew maintains large infrastructure, including roads, railways, waterworks and power plants. It hasn't missed a beat and at the end of November, management announced a further upgrade to full year expectations following strong activity in its Rail division. It is cash generative, has acquired well, and has the financial resources to continue to do so. The shares trade on just 12 times conservative forecast earnings despite record levels of revenue for the year, new framework extensions secured, and a positive outlook. The share price fall through much of 2022 was despite, rather than because of, Renew's operational performance and near-term prospects.

RWS uses digital technology and artificial intelligence to help its customers market themselves and secure their intellectual property across different languages and countries. It has built up an excellent global customer base over decades of successful execution, has so far rewarded investors with 15 years of unbroken dividend growth, and is rich with cross and upselling potential following its 2020 acquisition of translation software business SDL. The group is investing for future growth and does so from a position of considerable strength, backed by a secure base of largely repeat and contractually recurring revenue. The shares, however, have rarely traded lower across multiple valuation metrics despite the recent share price recovery.

But profit warnings remain a risk

Profit warnings increased by 50% in 2022, with 169 announced in the second half alone - the highest number in an H2 since 2015. The percentage of UK-listed businesses warning on profits in the year was equal to the proportion of companies that disappointed in 2008,

with increased costs and overheads cited as key drivers. While share prices partially rebounded in the fourth quarter, there remains scope for earnings downgrades in the first half of 2023.

Such misses have been harshly punished by the market. This is in part a more cautious investor psychology, but also results from consistent UK-focused equity fund outflows. Last year was the second in a row of such outflows, with net selling in every month, for a record total outflow of £8.4 billion. This is weighing on prices, but also leading to some attractive valuations.

Legal services group Knights derated significantly in the year but partially recovered in the fourth quarter. Recent results were better than some feared and we view the valuation at less than five times earnings as unduly harsh. Management is focused on driving organic growth and improving cash conversion. If achieved, this should drive a healthy rerating.

Meanwhile, kettle safety and heating component designer Strix ran into issues in the final quarter due to China lockdowns leading to the temporary closure of customer warehouses. While this affects financial year 2022 results, the December change in China's lockdown policy gives hope that the risk of repeat disruption is receding. Beyond that, the recent acquisition of Billi is well priced, and gives Strix a great chance of achieving its financial targets.

A resilient performance despite the backdrop

These changing times reinforce our more enduring views on investment strategy, which we have detailed previously. We remain focused on maintaining balanced portfolios of high-quality, profitable, well-managed companies.

We look for businesses with high operating margins (earnings from core operations divided by sales), because they are indicative of pricing power and inflation resilience. Their profits are typically well backed by cash flows, which can be invested internally in growth projects for healthy returns. These types of enterprises are well placed to grow through the business cycle, whatever the weather.

Companies such as Bioventix (clinical diagnostics), Tracsis (rail industry software), and Smart Metering Systems (digital utility meters and grid-scale batteries) are operating robustly in growing markets. All are well managed with clear growth plans, and all have aptly navigated the more inflationary world. Their shares have comfortably outperformed the benchmark AIM index over the past year as a result.

Others, including scientific instrument manufacturer Judges Scientific and asset management consultant Alpha Financial Markets Consulting have confirmed profits ahead of previous expectations, prompting rallies in their respective share prices, while the likes of telco billing and CRM systems supplier Cerillion and health IT developer Instem have reported record financial results or contract wins. Their progress is supported by high margins, strong cash conversion, and favourable long-term trends.

An unjustified small-cap discount

Rising interest rates may have dented valuations, and pressure on profit margins from rising costs poses a short-term risk to earnings in some parts of the market, but we still believe smaller growth company equity remains an attractive long-term investment. We see many potentially mispriced companies in the market, and a lack of appreciation for long-term growth potential. This makes us optimistic. It might not take much to improve sentiment and valuations from this low base.

Indeed, smaller company investment trust asset values largely recorded stronger returns than their benchmarks over Q4. Notably for sentiment, share prices of these trusts grew at a higher rate, closing the stubbornly wide discounts that persisted throughout 2022 – in one case the discount narrowed from 15% in June 2022 to 8% in December 2022. This suggests that investors are prepared to invest in smaller companies, assisted in part by sterling's strength over the final quarter of 2022.

Meanwhile, a robust operational performance despite the market sell-off means that our target portfolio currently trades at a notable 14.5% discount to what its value would be if you calculate it using its average PE ratio over the past five years. That discount increases to 21.5% on a price to free cash flow basis (i.e when valued against the cash portfolio businesses have left over after paying day-to-day bills and maintaining their equipment, buildings and other important assets). We believe these are attractive multiples given the long-term quality and growth skew of these investments.

Nearly two-thirds of our holdings either have no debt or have more cash than debts. Of the remainder, their net debts are less than one year's earnings before interest, tax and amortisation (EBITDA) and interest expenses are covered many times over by earnings. Dividend cover is similarly comfortable for the portfolio and many of our companies enjoy best-in-class operating margins.

There remains a wide range of possible outcomes in the year ahead, but we are encouraged by our portfolio's resilience to date and remain enthused by our companies' financial health, profitability, and growth prospects.

The Autumn Statement 2022

The Government's objective of putting the public finances on a sustainable path unleashed a further freeze on Inheritance Tax nil rate band. The nil rate band now remains frozen at £325,000 until 2027/28 - extending then Chancellor (now Prime Minister) Rishi Sunak's spring 2021 freeze by two years - expected to push up Inheritance Tax receipts from £6.1 billion in 2021/22 to £7.8 billion in tax year 2027/28 - a 28% increase, according to Office for Budget Responsibility figures. Measures could have gone further; however, an election is being positioned for 2024. If the nil rate band had risen in line with inflation, today it would be worth £457,000. Projecting forward to the 2027/28 tax year (assuming 3% inflation) it would be over £500,000.

Stewardship

As a responsible investor, Rathbones prioritises engagement where we can make the most impact in addressing systemic environmental and social challenges and add value to clients' portfolios. During the reporting period, Rathbones engaged with six portfolio companies on a variety of ESG (environmental, social and governance) issues. Following engagement we will be monitoring diversity, director independence, director over boarding, remuneration and pre-emption rights.

Preemption rights are central to investor protections, the rights of first refusal on new issues of shares; Rathbones encourages investee companies to commit to follow the Pre-Emption Group guidelines to protect existing investors' interests. We look forward to updating you further on our stewardship activities.

Portfolio strategy

This portfolio takes a long-term approach to investing. Rathbones take the approach of investing in AIM traded companies that stand up on their own right while qualifying for relief from inheritance tax.

Alternative Investment Market (AIM)

AIM set out in 1995 to provide smaller, growing companies earlier and more efficient access to the public markets. In December 2022 AIM hosted 816 companies, a notable decline from 852 in the prior year, due to a subdued IPO environment, and trading related de-listings or acquisitions. AIM's constituents owned a combined £93.2 billion in value in December 2022 reflecting a difficult 12 month period for growth companies, declining from £150 billion at the close of 2021. There are 15 ventures valued at over £1 billion, co-existing with a vibrant venture capital market and early stage opportunities.

Environmental factors are being prioritised by investors and The London Stock Exchange's Green Economy Mark recognises ventures generating over 50% of revenues from sustainable activities. Many AIM companies are transitioning to a low-carbon economy and account for 46% of companies with the Green Economy Mark.

From September 2018 all AIM companies adopted a governance code and then 'comply or explain', increasing disclosure and confidence.

The Rathbones investment approach

Profitable, established, cash generative AIM-traded companies with growth characteristics and strong competitive advantages - a preference for quality opportunities that should stand the test of time. This is a bottom-up stock selection approach favouring highly visible revenue streams in growth markets with little direct exposure to the consumer, avoiding airlines, retailers, and pawnbrokers. Banks, resources, recruiters, and car dealers also don't meet the criteria.

Benchmark

In the final quarter of 2022 the FTSE AIM All-Share Index improved 3.6%. As a benchmark for Specialist Tax Portfolio performance though it's not ideal and not a like-for-like comparison. Not all AIM shares qualify for Business Relief meaning the relevance of the index is limited for this tax-advantaged portfolio strategy. The FTSE AIM All-Share Index is highly concentrated: the largest 10 constituents account for 20% of the index's total value. The index really has limited application other than a rough indication of smaller company performance.

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For further information (including the amounts covered and the eligibility to claim) please refer to the FSCS website www.fscs.org.uk.

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